

Internal Revenue Service
memorandum

CC:TL-N-4295-90

Br4:HGSalamy

date: **MAR 14 1990**

to: District Counsel, Manhattan NA:MAN
Attn: KCreilly/MABatt

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is a preliminary response to your March 2, 1990, request for tax litigation advice in the above-entitled case. In an opinion filed on [REDACTED], the District Court concluded that the taxpayer was not equitably estopped to maintain a suit for refund with respect to an item which was later discovered after the execution of a Form 870-AD. You seek our advice regarding the extent to which the Service may now utilize the doctrine of set-off to reduce the amount of the asserted overpayment (but not below zero).

ISSUE

In a situation where the District Court did not hold the Form 870-AD agreement invalid, to what extent can the Service argue set-off with respect to a refund suit where the taxpayer is claiming an overpayment on account of a later discovered item.

PRELIMINARY CONCLUSION

Preliminarily, we conclude that the Service may argue set-off with respect to any non-Form 870-AD adjustment to reduce the claimed overpayment (but not below zero).

DISCUSSION

We have considered the extensive discussion contained in your incoming request regarding the possible options open to the Service in this litigation in the wake of the District Court's opinion. Inasmuch as the court did not invalidate the Form 870-AD agreement but merely concluded that equitable estoppel did not apply as to the later discovered item, it is our view that the Service is limited in its set-off approach to non-Form 870-AD adjustments. As you know, it is Service position that the Form 870-AD is not a binding contract. See O.M. 16949, [REDACTED]

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██████, CC-1970-372 (July 1, 1970). The only way by which a Form 870-AD agreement is enforceable is via equitable estoppel. We think that the District Court, citing the appropriate case law, was correct in concluding that equitable estoppel did not apply in this situation. If the Service desired to close the years with finality, it should have secured an I.R.C. § 7121 closing agreement.

Also, for the Service to utilize the Form 870-AD adjustments as set-off would probably mean that taxpayer would be entitled to do the same thing. See and compare *Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct. Cl. 1975) (taxpayer set-off to Government set-off permissible).

Because Form 870-AD is an Appeals form, we are coordinating what should be correct Service position with the National Director of Appeals. Once we have received their views and reconsidered the matter, we will advise you further. In the meantime, if you have any questions, please call Mr. Salamy at FTS 566-3345.

MARLENE GROSS
Assistant Chief Counsel
(Tax Litigation)

By:



HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

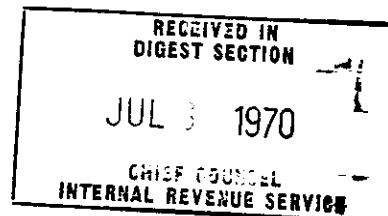
Enclosure:
O.M. 16949

Rec'd 0 m. 16949

Income tax; [REDACTED]; \$ [REDACTED].

1. Whether the refund suit was barred by a Form 870-AD settlement or equitable estoppel.
2. Whether the issuance of plaintiff's stock in exchange for stock of another corporation was a nontaxable exchange under section 112(b)(5) of the 1939 Code.

Question 1. Relying chiefly on Botany Worsted Mills v. United States, 278 U.S. 282 (1929), the Tenth Circuit reversed the District Court's holding that "the Form 870-AD agreement became a binding bilateral agreement when it was accepted." It also disagreed with the District Court's conclusion that equitable estoppel applied, observing that it favored the "strict" construction of the doctrine of equitable estoppel represented by cases such as Joyce v. Gentsch, 141 F.2d 891 (6th Cir. 1944), United States v. Prince, 348 F.2d 746 (2nd Cir. 1965), and Arthur V. Davis, 29 T.C. 878 (1958), rather than the "liberal quasi type of estoppel" represented by cases such as Guggenheim v. United States, 77 F. Supp. 186 (Ct. Cl. 1948), Daugette, et al. v. Patterson, 250 F.2d 753 (5th Cir. 1958) and Cain v. United States, 255 F.2d 193 (8th Cir. 1958). The Tenth Circuit said that it could "find no false representation" by plaintiff and that "the facts do not indicate a strong case of reliance and detriment." The Government argued that for settlement purposes it had conceded a delinquency penalty and had agreed to a reduced value for the sheep assets received by plaintiff and that in reliance on the Form 870-AD agreement it had allowed the statutory period on protective



assessments against plaintiff's stockholders to run. However, the Tenth Circuit pointed out that the assessment period for one of the shareholders had expired before plaintiff filed the Form 870-AD on [REDACTED], and that the assessment period for the remaining [REDACTED] shareholders expired on [REDACTED], prior to acceptance on behalf of the Commissioner on [REDACTED], and that the Form 870-AD had no effect until accepted. Furthermore, the Tenth Circuit remarked that the shareholders had not used a stepped-up basis when they sold their stock in [REDACTED] (so that they included in their [REDACTED] gains the unreported gains for [REDACTED]). Recognizing the factual weakness of the case as well as the absence of a direct conflict, this office recommended no certiorari.

The current litigation policy of the Service with respect to Form 870-AD settlements is set out in a letter to the Department of Justice dated May 19, 1970. Briefly, the Service now agrees that these settlements should be defended solely on the basis of equitable estoppel and only where all of the following prerequisites are met: (1) assessment was not barred on the effective date of the settlement but was barred on the date of the repudiation by the taxpayer; (2) the settlement reflected a concession by the Service of an adjustment (in whole or in part) which it was proposing in good faith at the time of the settlement and which still had merit at the time of the subsequent litigation; and (3) an issue raised by the taxpayer in the litigation is one which the taxpayer conceded (in whole or in part) at the time of the settlement and which the Government can defend on the merits at the time of the litigation.

Question 2. Reversing the District Court, the Tenth Circuit held that the issuance of plaintiff's stock to members of the [REDACTED] family in exchange for stock in [REDACTED] was a taxable exchange, because the amount of plaintiff's stock received by each of the [REDACTED] family was not "substantially in proportion" to his interest in the stock which he transferred to plaintiff, as required by section 112(b)(5) of the 1939 Code. In determining that the

"substantially in proportion" requirement was not met, the Tenth Circuit rejected the "control" test urged by the Government. Mather & Co. v. Commissioner, 171 F.2d 864 (3rd Cir. 1949). It adopted instead the "relative value" test. Bodell v. Commissioner, 154 F.2d 407 (1st Cir. 1946); United Carbon Co. v. Commissioner, 90 F.2d 43 (4th Cir. 1937); and Commissioner v. Lincoln-Boyle Ice Co., 93 F.2d 26 (7th Cir. 1937). Since the "substantially in proportion" requirement was not carried over to the 1954 Code (Reg. sec. 1.351-1(b)(1)), the question was not considered to be sufficiently important administratively to merit a petition for certiorari.

Recommendation:

No certiorari.

/s/ Thomas D. Spivey
Technical Asst. to Director

APPROVED:

(Signed) K. Martin Worthy
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K. MARTIN WORTHY
Chief Counsel

Wds
6-16-70